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Proposed statement on auditing standards : Client representations;Client representations; Exposure draft (American Institute of Certified Public Accountants), 1977, Jan. 31

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

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EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS: CLIENT REPRESENTATIONS

JANUARY 31, 1977

Issued by the Auditing Standards Executive Committee of the
American Institute of Certified Public Accountants
For Comment From Persons Interested in Auditing and Reporting

Comments should be received by March 31, 1977, and addressed to
Auditing Standards Division, File Ref. No. 4260
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

January 31, 1977

To Practice Offices of CPA Firms;
Members of Council; Technical
Committee Chairmen; State Society
and Chapter Presidents, Directors,
and Committee Chairmen; Organizations
Concerned With Regulatory, Supervisory,
or Other Public Disclosure of Financial
Activities; Persons Who Have Requested
Copies

An exposure draft of a proposed Statement on Auditing Standards entitled "Client Representations" accompanies this letter.

This proposed Statement requires the auditor to obtain written representations from management relating to its knowledge or intent when he believes they are necessary to complement his other auditing procedures. However, representations from management are not a substitute for the application of other auditing procedures necessary to afford the auditor a reasonable basis for his opinion on the financial statements. The draft also contains a list of matters for which a written representation should ordinarily be obtained.

Comments and suggestions on any aspect of the enclosed draft are sought and will be appreciated. They should be addressed to the Auditing Standards Division, File Ref. No. 4260, at the AICPA, by March 31, 1977. The Auditing Standards Executive Committee will be interested particularly in the reasoning underlying comments and suggestions.

Sincerely,

Kenneth P. Johnson

Kenneth P. Johnson, Chairman
Auditing Standards Division

John F. Mullarkey

John F. Mullarkey, Director
Auditing Standards Division

PROPOSED STATEMENT ON AUDITING STANDARDS

CLIENT REPRESENTATIONS

1. This Statement establishes a requirement that the independent auditor obtain certain written representations from management as a part of an examination made in accordance with generally accepted auditing standards and provides guidance concerning the representations to be obtained.[1]

Reliance on Management Representations

2. During an examination, management makes many representations to the auditor, both oral and written, in response to specific inquiries or through the financial statements. Such representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of other auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements. Written representations from management ordinarily confirm oral representations given to the auditor and indicate and document the continuing appropriateness of such representations.

3. The auditor obtains written representations from management to complement his other auditing procedures. In many cases, the auditor applies auditing procedures specifically designed to obtain corroborating information concerning matters that are the subject of written representations. For example, after the auditor performs the procedures prescribed in Statement on Auditing Standards No. 6, "Related Party Transactions," even if the results of those procedures indicate that transactions with related parties have been properly disclosed, he should obtain a written representation to document that management has no knowledge of any such transactions that have not been disclosed. In some cases involving written representations, the corroborating information that can be obtained by the application of auditing procedures other than inquiry is limited. When a client plans to discontinue a line of business, for example, the auditor may not be able to obtain information through other auditing procedures to corroborate the plan or intent. Accordingly, the auditor should obtain a written representation to provide confirmation of management's intent. Unless the auditor's examination reveals evidential matter to the contrary, his reliance on the truthfulness of management's representations is reasonable.

Obtaining Written Representations[2]

4. The auditor should obtain written representations from management relating to its knowledge or intent when he believes they are necessary to complement his other auditing procedures. The auditor should ordinarily obtain written representations concerning the following matters:

a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles or other comprehensive basis of accounting.

b. Availability of all financial records and related data.

c. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.

d. Absence of unrecorded transactions and related assets or liabilities.

e. Information concerning related party transactions and related amounts receivable or payable.[3]

f. Compliance with aspects of contractual agreements that are unrelated to, but may affect, the financial statements.

g. Information concerning subsequent events.[4]

h. Irregularities involving management or employees.

i. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.

j. Plans or intentions that may affect the carrying value or classification of assets or liabilities.

k. Disclosure of compensating balance or other arrangements involving restrictions on cash balances, and disclosure of line of credit or similar arrangements.

l. Reduction of excess or obsolete inventories to net realizable value.

m. Losses from sales commitments.

n. Satisfactory title to assets, liens on assets, and assets pledged as collateral.

[1] For purposes of this Statement, the term *management* means any person(s) having responsibility for achieving the objectives of the organization and the concomitant authority to establish the policies and make the decisions by which such objectives are to be pursued. It normally includes members of the board of directors, the president, secretary, treasurer, any vice president in charge of a principal business function (such as sales, administration, or finance), and any other individual who performs similar policy-making functions.

[2] An illustrative representation letter from management is contained in the Appendix.

[3] See SAS No. 6.

[4] See SAS No. 1, sections 560.12 and 710.08.

o. Agreements to repurchase assets previously sold.

p. Losses from purchase commitments for inventory quantities in excess of requirements or at prices in excess of market.

q. Violations of laws or regulations that should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.[5]

r. Other liabilities and gain or loss contingencies as required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5.[6]

s. Unasserted claims that the client's lawyer has advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.[7]

t. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

5. Management's representations may be limited to matters that are considered individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on the limits of materiality for this purpose. Such limitations would not apply to those representations that are not directly related to amounts included in the financial statements, for example, items (a), (b), (c), and (i) above. In addition, because of the possible effects of irregularities on other aspects of the auditor's examination, a materiality limit would not apply to item (h) above.

[5] See SAS No. 17.
[6] See SAS No. 12, paragraph 5.
[7] *Ibid.*

6. In addition to the representations cited above, the auditor may determine, based on the circumstances of the engagement, that other matters should be specifically included in written representations from management.[8] For example, if a company excludes a short-term obligation from current liabilities because it intends to refinance the obligation on a long-term basis, the auditor should obtain a specific representation of management's intent to consummate the refinancing.

7. In certain instances, the auditor may wish to obtain other written representations from management in addition to evidential matter obtained through other procedures. For example, although the auditor may be satisfied with the method of pricing inventories, he may ask management to furnish a representation concerning inventory pricing.

8. If the independent auditor is reporting on consolidated financial statements, the written representations obtained from the parent company's management should specify that they pertain to the consolidated financial statements and, if applicable, to the separate financial statements of the parent company.

9. The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his report that may require adjustment to or disclosure in the financial statements, the representations should be dated as of the date of the auditor's report. They should be signed by members of management whom the auditor believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations.

[8] Certain AICPA audit guides require or recommend that the auditor obtain written representations concerning matters that are unique to a particular industry. This Statement does not supersede those requirements or recommendations.

10. Normally, the chief executive officer and chief financial officer should sign the representations. In certain circumstances, the auditor may want to obtain written representations from other individuals. For example, he may want to obtain written representations about the completeness of the minutes of the meetings of stockholders, directors, and committees of directors from the person responsible for keeping such minutes. Also, if the independent auditor examines the financial statements of a subsidiary but does not examine those of the parent company, he may want to obtain representations from management of the parent company concerning matters that may affect the subsidiary, such as related party transactions or the parent company's intention to provide continuing financial support to the subsidiary.

11. Management's refusal to furnish a written representation that the auditor believes is essential constitutes a limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion (see SAS No. 2, paragraphs 10 and 11). Further, the auditor should consider the effects of management's refusal on his ability to rely on other representations of management.

12. If the auditor is precluded from performing procedures he considers necessary in the circumstances, with respect to a matter that is material to the financial statements, even though he has been given representations from management concerning the matter, there is a limitation on the scope of his examination and he should qualify his opinion or disclaim an opinion (see SAS No. 2, paragraphs 10–12).

ILLUSTRATIVE REPRESENTATION LETTER

(Date of Auditor's Report)

(To Independent Auditor)

In connection with your examination of the (consolidated) financial statements of (name of client) as of (date) and for the (period of examination) for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly the financial position, results of operations, and changes in financial position of (name of client) in conformity with generally accepted accounting principles (other comprehensive basis of accounting), you have requested that we confirm to the best of our knowledge and belief, certain representations made to you.

1. We are responsible for the fair presentation in the (consolidated) financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (other comprehensive basis of accounting).

2. We have made available to you all —
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. We have disclosed to you all (There have been no) —
   a. Irregularities involving management or employees.
   b. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.

4. We have disclosed to you all plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

5. The following have been properly recorded or disclosed in the financial statements:
   a. Related party transactions as defined in SAS No. 6 and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.
   b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.
   c. Arrangements with financial institutions involving compensating balance or other arrangements involving restrictions on cash balances and disclosure of line of credit or similar arrangements.
   d. Agreements to repurchase assets previously sold.

6. We have disclosed to you (There are no) —
   a. Violations of laws or regulations that should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
   b. Other material liabilities and gain or loss contingencies as required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5.

7. We have advised you of all unasserted claims that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

8. There are no material transactions or related assets or liabilities that have not been properly recorded in the financial records.

9. Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.

10. The company has satisfactory title to all assets reflected in the financial statements, and there are no liens or encumbrances on such assets nor has any asset been pledged except as disclosed in the financial statements.

11. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.

12. Provision has been made for any material loss to be sustained as a result of purchase commitments in excess of normal requirements or at prices in excess of the prevailing market prices.

13. We have complied with all aspects of contractual agreements that are unrelated to, but may materially affect, the financial statements.

14. No events have occurred subsequent to the balance sheet date that would require adjustment to or disclosure in the financial statements.

(Name of Chief Executive Officer and Title)

(Name of Chief Financial Officer and Title)